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Corporate Successors Can Tap Historical Liability Insurance Policies

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Does a corporation that succeeds to another entity's liabilities acquire rights to that entity's insurance coverage for pre-acquisition operations? Several courts have answered this question in the affirmative. These courts have concluded that a corporate policyholder is entitled to defense and indemnity for pre-acquisition liabilities because liability insurance coverage follows the alleged liability by "operation of law."

Operation of Law Rule

The "operation of law" rule was recognized in a 1992 Ninth Circuit decision, *Northern Insurance Co. v. Allied Mutual Insurance Company*, 955 F.2d 1353 (9th Cir. 1992). In that case, Brown-Forman purchased California Cooler, a beverage company, pursuant to an asset purchase agreement. Brown-Forman was subsequently sued by the family of a child born with fetal alcohol syndrome and sought coverage for defense costs from Northern Insurance, California Cooler's insurance company. The Ninth Circuit applied a rule of product-line successor liability and found that even though the asset purchase agreement excluded the predecessor's liability insurance policies, the benefits of those policies transferred anyway by operation of law.

Several courts have extended this doctrine beyond product-line successor liability. For example, in *Total Waste Management Corp. v. Commercial Union Ins. Co.*, 857 F. Supp. 140 (D.N.H. 1994), the court extended the *Northern Insurance* doctrine to an environmental liability case. In that case, the seller sold certain assets, but continued its corporate existence after the asset sale. The purchaser was subsequently sued for presale environmental liabilities and sought coverage under the seller's historical policies. The court concluded that the insurance benefits transferred to the purchaser by operation of law under a theory of corporate succession. Likewise, in *B.S.B. Diversified Co. v. American Motorists Ins. Co.*, 947 F. Supp. 1476 (W.D. Wash. 1996), the court extended the product-line rule to a successor responsible for environmental cleanup where the events creating the liability occurred prior to the transfer of liability.

More recently, the Ohio Court of Appeals reaffirmed the well-accepted operation of law rule in the case of *The Glidden Company v. Lumbermens Mutual Casualty Co., et al.*, 2004 WL 2931019 (Ohio Ct. App. December 17, 2004). In that case, the Ohio Court of Appeals reversed the lower court's ruling and held that, although the rights and benefits to the historical liability policies did not transfer pursuant to the applicable corporate transactions, Glidden obtained rights to coverage under those policies as a matter of law. Specifically, the *Glidden* court held that "a corporation which succeeds to liability for pre-acquisition operations of another entity acquires rights to coverage by operation of law."

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In the last several years, insurance companies had been trying improperly to avoid their obligations for historic liabilities. One anti-policyholder decision adopting a formalistic, anti-insurance coverage approach held that rights to insurance coverage for pre-acquisition liabilities passed in corporate merger context, but not in certain other corporate transactions. The California Supreme Court in *Henkel Corporation v. Hartford Accident & Indemnity Co., et al.*, 129 Cal. Rptr. 2d 828 (Cal. 2003), rejected the well-established "operation of law" approach and concluded that a successor corporation was not entitled to a defense or indemnity from its predecessor's insurance companies for lawsuits alleging bodily injury as a result of exposure to the predecessor's chemical products.

The recent *Glidden* decision resoundingly rejected the conclusion of the *Henkel* court, and reaffirmed the earlier well-accepted operation of law doctrine, in holding that:

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RECENT DEVELOPMENTS

Pollution / Contamination Exclusion Doesn't Apply to Tainted Beverage Losses. *Pepsico, Inc. v. Winterthur International America Insurance Company.* On December 27, the New York Supreme Court, Appellate Division, affirmed a holding that a "seepage and/or pollution and/or contamination" exclusion in a first-party policy does not apply to product contamination that is not environmental in nature. Winterthur International America Insurance Company ("Winterthur") denied coverage to Pepsico, Inc. for losses in connection with the use of faulty raw ingredients supplied by third-party suppliers in their beverages, creating an off taste in the finished product, and rendering the products unsalable. Winterthur claimed that the exclusion applied based on the plain meaning of the word "contaminate." The Court explained that Winterthur's interpretation requires that the term "contamination" be read literally, while the New York Courts, in construing terms in pollution exclusion, favor a common-sense approach over a literal approach. Further, policy references to decontamination and debris removal in the context of removing pollutants from land and water, concern environmental pollution, not product contamination. The New York Court also stated that Winterthur's interpretation also contradicts the "common speech" and "reasonable expectations of a businessperson" who understands that standard pollution exclusions apply to environmental damages. The New York Court held that with more than one possible interpretation of the term "contamination," the exclusion is at least ambiguous.

—Claudie Ilie

INDUSTRY NEWS

Coverage Implications of Supreme Court Cleanup Contribution Decision. A recent Supreme Court decision handed policyholders another reason to think before undertaking voluntary environmental cleanups. Costs incurred voluntarily (in the absence of identifiable legal compulsion, *e.g.*, no regulatory letters or applicable laws) to cleanup environmental property damage generally

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> We believe the better-reasoned authority applies the operation of law theory. Courts applying this theory have continued to extend its application to more general successor liability situations. We find that a corporation which succeeds to liability for pre-acquisition operations of another entity acquires rights of coverage by operation of law. *This theory applies even where the acquisition was a purchase of assets or only part of a predecessor corporation*.

Glidden at *9 (emphasis added). The *Glidden* ruling, and the well-recognized decisions it follows, ensures that the insurance rights of corporate policyholders are protected regardless of the type of corporate transaction involved. It also prevents insurance companies from receiving an unfair windfall for a risk they promised to insure against and for which they were paid.

The "Increased Risk" Myth

Insurance companies' favorite mantra is that transferring insurance rights by operation of law "increases their risk" under the policy. They argue that corporate transactions may result in a situation where they would have to defend and indemnify multiple entities. This argument mistakenly assumes that insurance companies would never owe defense obligations to multiple policyholders. To the contrary, the possibility of defending and indemnifying multiple policyholders is a risk inherent in standard comprehensive general liability policies.

The "increased risk" argument also ignores the fact that the risks of corporate transactions already were present when the policies were written. In other words, the conclusion that a corporate transaction will "increase the risk" of the defense costs depends entirely on the false assumption that an organization cannot sell off the assets and liabilities of a business unit without the permission of its insurance company.

Occurrence-Based Liability Insurance Protects Policyholders Against "Incurred But Not Yet Reported" Losses

One of the main benefits of purchasing occurrence-based liability coverage is that it provides lasting protection. The benefits of insurance last as long as there is a possibility that someone might allege that the policyholder caused harm during the policy period. This protection against future claims is fundamental and basic to the occurrence form of coverage. In insurance speak, this protection is referred to as protection against incurred but not yet reported ("IBNR") losses. It means that an entity can purchase liability insurance protection at the time it engages in a potentially loss-causing operation and be assured that, as long as the amount of insurance

Q WHO SAID WHAT?

"Royal's actions are reminiscent of the dinner companion who orders the most expensive items on the menu, and then claims to have forgotten his wallet when the waiter brings the check."

Answer on page 3

purchased is adequate, it will have protection against future claims relating to that activity. Protection for IBNR claims is the essence of the protection provided by an occurrence policy.

The transfer of IBNR insurance benefits with the alleged IBNR liabilities: (1) furthers the public policy of risk spreading; and (2) furthers the public policy against forfeitures. First, it furthers the public policy of risk spreading, which occurs when liability insurance covers products liability claims. The courts that recognized strict products liability explicitly mentioned the ability of manufacturers to obtain liability insurance as a basis for this expansion of tort law. Retroactively separating alleged IBNR liability from the IBNR insurance benefits would prevent liability insurance from fulfilling its risk-spreading role.

Second, transferring IBNR insurance benefits with the alleged IBNR liabilities that they cover also furthers the public policy against forfeitures. In a typical sale of a business division, the seller transfers to the purchaser both the assets and certain liabilities relating to the operations of that business division. If a Court were to require insurer consent, there would be a significant forfeitures of insurance benefits, because there has not been a custom in the corporate deal market of obtaining insurance company consent for the transfer of accrued IBNR benefits.

Insurance companies are well aware that they may be called upon to defend or indemnify their policyholder for IBNR losses. They deal every day with IBNR losses and even deduct IBNR losses from their federal and state income taxes. Given the insurance industry's familiarity with the concept of IBNR losses, insurance companies cannot argue that they did not expect to pay, years after the fact, for injuries which occurred during their policy periods. The decisions following *Northern Insurance*, including the recent *Glidden* decision, reinforce the notion that occurrence-based liability coverage protects the policyholder against IBNR losses.

Anit-Assignment Clauses are Inapplicable After a Loss has Taken Place

Another flawed argument upon which the insurance companies rely is that a policy's anti-assignment clause prohibits the transfer of coverage unless the insurance companies' consent is obtained. This argument is inconsistent with the nature of occurrence-based liability coverage and the majority of jurisdictions nationwide. The majority of courts have held that the right to recover for pre-transaction liabilities may be freely assigned without the insurance company's consent notwithstanding the supposed "no-assignment" clause in the policy. Such an assignment does not interfere with the insurance company's right to choose its own indemnitee but merely involves the payment of a claim which has already accrued.

Several courts, including the *Glidden* court, have concluded that because the alleged injury took place prior to the transfer of assets, the insurance company is not exposed to any greater or lesser risk than the one bargained for when it initially evaluated the risk. Accordingly, the benefits of the insurance policies are transferred by operation of law irrespective of whether the physical policies themselves were actually transferred. In other words, the right to indemnity follows the

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are not recoverable under general liability insurance.

The 7-2 decision limited available claims and, hence potential liability, under the federal Superfund law known as CERCLA, 42 U.S.C. §9601 *et seq.* Justice Thomas, writing for the majority, held that CERCLA Section 113(f)(1) does not authorize contribution actions by a potentially responsible party ("PRP") against another PRP for "voluntary" cleanup costs. *Aviall Servs., Inc. v. Cooper Indus., Inc.*, 125 S.Ct. 577 (2004). The case likely will discourage certain cleanups and may be used to support alleged defenses to coverage based on exclusions involving "voluntary" actions.

The Court explicitly refused, however, to address whether an implied right of contribution might exist under a separate provision of CERCLA, Section 107, leaving a window of opportunity open on remand and otherwise for policyholders and property owners.

In a manner somewhat similar to fairly recent holdings in California in the insurance context which draw a distinction between government-mandated cleanups as opposed to private lawsuits alleging environmental property damage, the Court interpreted the "clear meaning" of CERCLA's Section 113(f)(1) to establish a right of contribution for a PRP plaintiff only after it has been subject to a lawsuit under CERCLA Sections 106 or 107(a). The Court declined to examine legislative history or otherwise engage in any statutory interpretation regarding the purpose of CERCLA, basing its holding instead solely on its reading of the text of CERCLA itself.

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a WHO SAID WHAT?

Lexington Insurance Company
Reply Memorandum of Law in Support of Defendant's Motion for Summary Judgment, dated Oct. 2, 2002 at 2, *Royal Ins. Co. of America v. Lexington Ins. Co.*, No. 02-CV-2085, SDNY.

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alleged liability rather than the policy itself. This is simply how liability insurance works.

Conclusion

Corporate successors seeking insurance coverage for pre-transaction liabilities can tap into historical liability policies. The more recent and better-reasoned authorities have consistently upheld the operation of law rule and enforced the free transfer of insurance benefits with the associated pre-transaction liabilities. ■

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Anyone considering undertaking environmental remediation should carefully weigh the potential implications of this decision on obtaining contribution for cleanup costs from other responsible parties or via insurance, especially historic comprehensive general liability insurance. ■

—John G. Nevius

Mark Your Calendar

Insurance Issues Update
March 3, 2005

4:00 - 6:00 p.m. (cocktail hour from 6:00 - 7:00 p.m.)

The Country Club of Fairfax
5110 Ox Road
Fairfax, VA 22038

FREE Seminar

Topics to be discussed include:

- Current Issues in Insurance
- Pros and Cons of Self-Funding
- Directors & Officers Liability Insurance: Getting Your Money's Worth
- Insurance Required by Commercial Mortgages

Application for CLE Accreditation of this course or program in Virginia is currently pending. For more information or to register, please visit our website at www.andersonkill.com or contact Michele Elie at (212) 278-1318.

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